March 2015

PACIFIC FUNDS

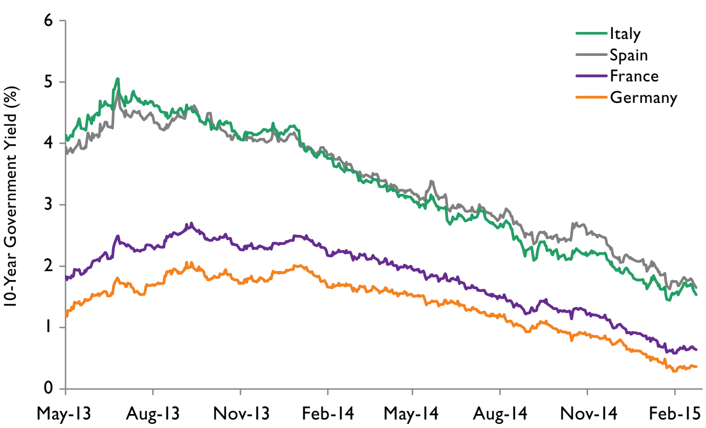
Manager Insight Series

Commentary from Pacific Asset Management, the subadvisor to the Pacific Funds℠ Fixed-Income Funds.

The Euros Are Coming

The gap between U.S. and European bond yields presents an interesting value case for U.S. corporate bonds. Central bank policy, deflationary concerns, and diverging economic outlooks have all been cited as reasons for the difference. In this article, we comment on factors driving this divergence and our rationale for favoring U.S. corporate bonds, especially when viewed from a U.S. investor's perspective.

Chart 1: Central bank policy, deflationary concerns, and weak growth outlooks have led to a Euro-area rates decline



Source: Barclays, as of February 28, 2015.

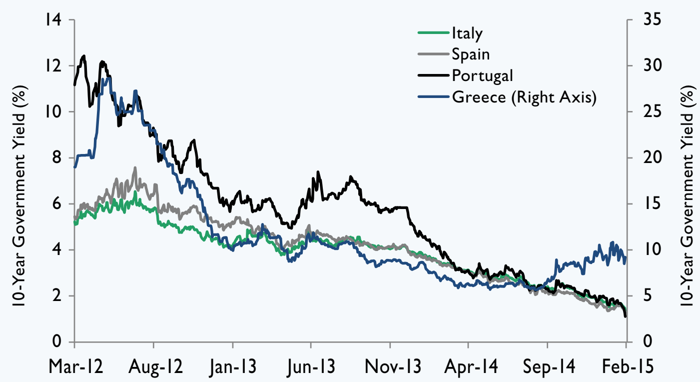
Monetary Policy—A Key U.S. Export

Over the past two years, European sovereign bond yields have moved to strikingly low levels, with some European government bonds trading at yield levels never before seen in modern economic history (Chart 1). While disinflationary pressures and stagnant growth are the foundation, at the heart of the broad-based decline has been the European Central Bank (ECB). The ECB's liquidity provisions and financial backstops have helped to reduce the short-term systemic risk, and recently announced asset purchase programs have pushed yields lower. The ECB has moved monetary policy into quantitative easing (QE), assisted by a roadmap created by the U.S. Federal Reserve (Fed)

Key Takeaways

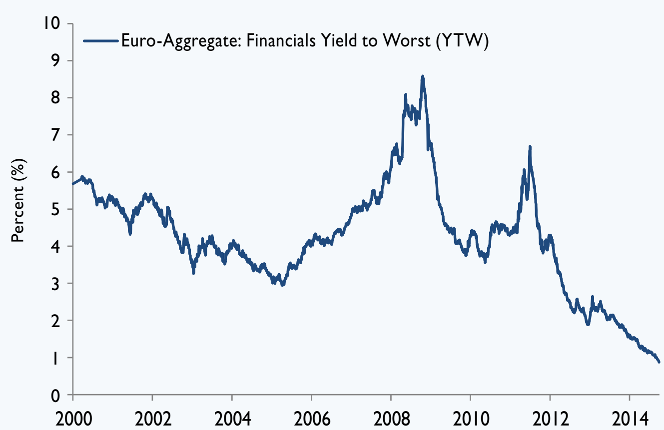
European sovereign and financial bonds have moved to strikingly low yields, resulting in historically low risk premiums. Efficient or not, the importance of the ECB has been paramount to this.

ECB policy, deflation concerns, and muted sovereign risks have led to a decline in government bond yields



Source: Barclays, as of February 28, 2015.

European financials reach record low yields



Source: Barclays, as of February 28, 2015.

several years prior. In tune with the ECB, Swiss and Swedish central banks have moved policy rates into negative territory (Table 1) as the broader region struggles to grow.

QE programs implemented or announced by the ECB, Bank of Japan (BOJ), and Riksbank in Sweden have resulted in negative real or nominal rates. This may limit the U.S. Federal Reserve's ability to materially raise the federal funds rate in the near term. U.S. Treasury yields are now higher than nearly all other Group of Seven (G-7) governments. U.S. Policy hikes could accelerate an already strengthening U.S. dollar, hurting exports and economic growth. Considering that Janet Yellen and the U.S. Federal Reserve have emphasized the growing interdependence of central bank policies, these factors point to a more "patient" trajectory for Fed tightening.

Table 1: Central Bank Rates

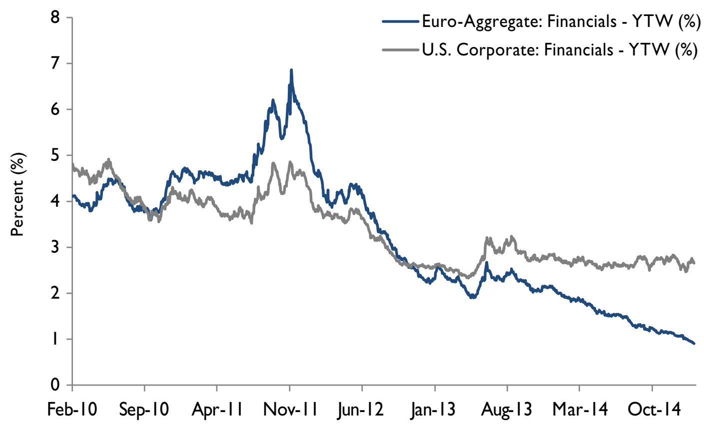
Country	Rates
United Kingdom	0.50%
United States	0.00%–0.25%
Denmark	0.05%
European Union	–0.20%
Sweden	–0.10%
Switzerland	–1.25%

Source: St. Louis Federal Reserve, as of February 28, 2015

The Valuation Gap

European corporate bond markets have been strong beneficiaries of falling risk premiums and sovereign yields. The ECB has been successful in pushing risk-free returns near zero, incentivizing market participants to move out on the risk spectrum. Financials have particularly benefited, with the Barclays Euro-Aggregate Financials Index now trading at a record low yield of 0.87% (Chart 2).

Chart 2: Yields of Euro financials vs. U.S. financials



Source: Barclays, as of February 28, 2015.

In contrast, U.S. corporate bond yields have remained elevated due to an improving growth outlook, a central bank communicating tightening monetary policy, and volatility surrounding energy. This has led to U.S. corporate bond markets having substantially higher yields than European peers (Table 2). In our opinion, the valuation gap is a relative value advantage for U.S. corporate bonds.

Table 2: The U.S. yield advantage is broad-based

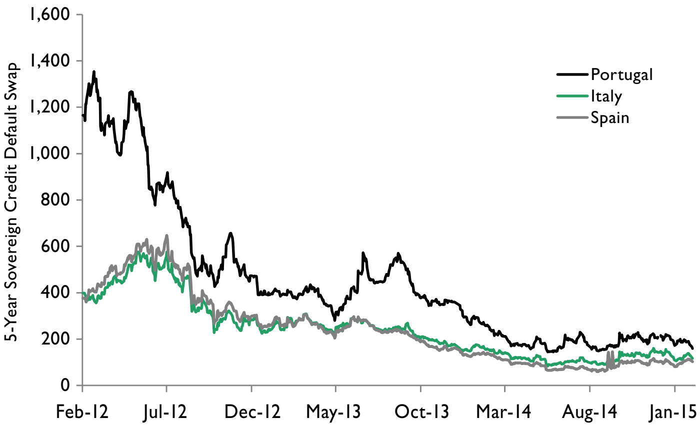
Index	Yield (%)
Barclays U.S. Corporate	2.93
Barclays Euro-Aggregate Corporates	0.84
Credit Suisse Leveraged Loan	5.81
Credit Suisse Western Europe Leveraged Loan	4.74
Credit Suisse High Yield	6.39
Credit Suisse Western Europe High Yield	4.48

Source: Barclays, Credit Suisse, as of February 28, 2015.

Beyond simple yield advantages, structural and fundamental reasons advocate for U.S. corporate bonds. The structural challenges of a European Economic and Monetary Union continue to present short-term bouts of volatility and long-term systemic risk. Sovereign risk premiums are remarkably absent in peripheral countries (Chart 3), reducing the margin of safety associated with European credit spreads. Weak economic growth, soft corporate profits, and the specter of deflation warrant caution within European corporate bonds.

In contrast, the U.S. economic and fundamental outlook is supportive of corporate bond markets. Corporate health is sound, economic activity continues to improve, and liquidity needs have been largely derisked given the substantial refinancing over the past few years. The U.S. Federal Reserve may be seeking to tighten policy in 2015; however, the pace of rate hikes may be muted. This may keep Treasury yields range-bound and supportive of duration risk relative to European bond markets.

Chart 3: Remarkably absent risk premiums leave little margin of safety in peripheral sovereign bonds



Source: Bloomberg, as of February 23, 2015.

Summary

Given the decline in European sovereign yields, and virtually vanishing risk premiums in peripheral countries, a simple yield advantage presents an interesting case for U.S. corporate bonds. Factor in divergent currencies, U.S. economic strength, and healthy U.S. corporations, and an investor would be hard pressed to argue favoring Euro-based corporate bonds versus U.S. corporate bonds. As a result of these factors, we would expect foreign capital, European capital in particular, to continue to flow into the U.S. markets. As corporate bond investors, we see this dynamic, along with other domestic factors, as an aspect that will help provide a ceiling for U.S. spreads and rates.

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Yield to Worst (YTW) is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

Barclays U.S. Corporate Index includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be registered with the Securities and Exchange Commission (SEC).

Barclays Euro-Aggregate Corporates Index is the corporate component of the Pan-European Aggregate Index which covers eligible investment grade securities from the entire European continent. The primary component is the Euro-Aggregate Index. In addition, the Pan-European Aggregate Index includes eligible securities denominated in British pounds (GBP), Swedish krona (SEK), Danish krone (DKK), Norwegian krone (NOK), Czech koruna (CZK), Hungarian forint (HUF), Polish zloty (PLN), Slovenian tolar (SIT), Slovakian koruna (SKK), and Swiss franc (CHF).

Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the U.S. dollar denominated leveraged loan market.

Credit Suisse Western European Leveraged Loan Index is designed to mirror the investable universe of the Western European leveraged loan market. The index includes loans denominated in the U.S. dollar and Western European currencies.

Credit Suisse High Yield Index is designed to mirror the investable universe of the U.S. dollar-denominated high yield debt market. Issues must be U.S. dollar denominated straight corporate debt, including cashpay, zero-coupon, stepped-rate and pay-in-kind (PIK) bonds. Floating-rate and convertible bonds and preferred stock are not included.

Credit Suisse Western European High Yield Index is designed to mirror the investable universe of the Western European high yield debt market. The index includes issues denominated in the U.S. dollar and Western European currencies.

Indexes are unmanaged and cannot be invested in directly.

About Pacific Asset Management

Founded in 2007, Pacific Asset Management specializes in credit-oriented fixed-income strategies. Pacific Asset Management is a division of Pacific Life Fund Advisors LLC, an SEC-registered investment adviser and a wholly owned subsidiary of Pacific Life Insurance Company (Pacific Life). As of December 31, 2014, Pacific Asset Management managed approximately $4.8 billion. Assets managed by Pacific Asset Management include assets managed at Pacific Life by the investment professionals of Pacific Asset Management.

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Effective December 31, 2014, Pacific Life Funds and its family of mutual funds changed its name to Pacific Funds. In addition, individual funds were also renamed. For more information, please visit www.PacificFunds.com.
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